Dividend income at discount prices

Closed end funds can trade at a discount to their net asset value, providing opportunities to pick up undervalued assets.

CEFs are investor funds that are pooled together and then used to buy underlying investments like stocks,bonds, and commodities. In that way, they work just like mutual funds or exchange traded funds (ETFs). However, the similarities end there.

Mutual funds and ETFs are considered open-ended funds. This means that additional units in the funds may be issued or redeemed as cash comes in and out of the fund from investors. The number of units that can be outstanding is theoretically unlimited.

CEFs on the other hand issue shares at the time the fund is created, and no new shares are issued unless there is a secondary offering to the market. Hence, the term "closed end".

Open-ended funds dominate the mutual fund marketplace in volume and assets under management. With open-ended funds, the purchase and sale of fund shares take place directly between investors and the fund company. There's no limit to the number of shares the fund can issue.

Closed-end mutual funds issue only a specific number of shares and do not issue new shares as investor demand grows. Prices are not determined by the net asset value (NAV) of the fund but are driven by investor demand

To discuss the potential discount available in CEFs, we need to understand how the price is determined. When looking at mutual funds, CEFs and ETFs, the price, or NAV is calculated as the total assets on hand (fund holdings), less liabilities, divided by the number of shares outstanding.

Talking Indexes

Calculating the CEF discount

When it comes to CEFs investor sentiment and the limited number of shares available play a role in determining discounts and premiums to NAV. Just as any investment, investors may not be too keen on buying a specific sector or strategy at a given time.

This creates a discount price for the shares against NAV. This means that you can buy shares in the CEF at a discount to what the fund is worth. For example, a CEF could hold dividend paying stocks in the fund with a yield of five per cent. The actual value of the fund (NAV) is $10, and the price at which you can purchase the fund is $9.50, representing a five per cent discount to the NAV.

What does this mean to you? If you had $100,000 to invest in the fund you would receive 10,526 units ($100,000/$9.50) and receive $526 in income annually. If you had to buy the fund at NAV of $10, you would only receive 10,000 units ($100,000/$10) and receive $500 in income annually. By being able to purchase at a discount you increased your annual income by 5.20 per cent ($526/500).

Now ask yourself, what happens if that discount now closes and moves closer to its actual NAV or even to a premium to NAV? You can potentially sell your shares at the higher price for a capital gain. In the meantime, you get paid to wait.

CEFs are available globally on most markets including the US and Canada. However, just like any other investment you need to know what is under the hood of the CEF. Does the CEF use leverage? How much? What are the underlying securities? Who is the manager? Also, where is the CEF best held to minimize taxes?

CEFs provide an opportunity to complement your income generating investment portfolio and are worth considering.

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